78-1425

Supreme Court, U.S.
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TO THE UNITED STATES SUPREME COURT

JAMES V. and ESTHER R. COLE
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent

PETITION FOR WRIT OF CERTIORARI

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pro se

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UNITED STATES SUPREME COURT

JAMES V. and ESTHER R. COLE	)	
	)	
Petitioners,	)	Tax Court Docket
	)	No. 5403-72
vs	)	
	)	Court of Appeals
COMMISSIONER OF INTERNAL REVENUE	)	Docket No.
	)	77-1566
Respondent	)	

PETITION

Petitioners respectfully petition the Supreme Court of the United States to bring up for review, by writ of certiorari from the United States Court of Appeals for the Ninth Circuit, Tax Court Docket No. 5403-72, Court of Appeals Docket No. 77-1566.

The subject case was entered in the United States Tax Court as James V. and Esther R. Cole vs. Commissioner of Internal Revenue, Docket No. 5403-72. The case was consolidated, for purpose of trial, with case No. 802-73. An Opinion which combined the two cases was filed by the Tax Court on September 25, 1975, as T. C. No. 105 (a copy of

which is included separately), and a separate decision for case No. 5403-72 was entered on November 4, 1976.

The decision of the Tax Court was appealed to the United States Court of Appeals for the Ninth Circuit, again consolidated with T. C. case No. 802-73, and a consolidated Opinion was filed on November 22, 1978 (a copy of which is separately included).

GROUNDS ON WHICH JURISDICTION INVOKED

The Opinion to be reviewed was filed on November 22, 1978, by the United States Court of Appeals for the Ninth Circuit.

The statutory provision allowing review of the Court of Appeals' opinion is contained in Section 7482 of the Internal Revenue Code of 1954, in the manner provided in Section 1254 of Title 28 of the United States Code.

A petition for a writ of certiorari was mailed to the Supreme Court of the United States, properly addressed, on February 15, 1979, which petition was returned to petitioners on February 23, 1979, for revision. This petition constitutes the revision of the petition mailed on February 15, 1979.

QUESTION PRESENTED FOR REVIEW

Is petitioner's income clearly reflected by the computation of taxable income under the "method" used in the Statutory Notice of Deficiency upheld by Decision of the Tax Court, and Opinion of the United States of Court of Appeals for the Ninth Circuit?

For the purpose of this review petitioners acquiesce to the Opinion of the Tax Court as expressed on the cover page of 64 T. C. No. 105, Appendix infra, i.e.: "Held, no binding contract existed on November 26, 1968"; and, "Held further, petitioners' method of accounting for prepaid interest does not clearly reflect income".

For the purpose of this review petitioners also acquiesce to the Court of Appeals' Opinion as expressed on the cover page of Opinion No. 77-1566 to the extent that the Commissioner required, not allowed, the Coles to deduct interest ratably over the forty-month period for which it was paid.

The question presented here is:

1. Does a divided and inconsistent method of accounting, not properly denominated either a cash nor an accrual system, clearly reflect income under the meaning of 26 U.S.C. Section 446(b) and Regulation Section 1.446-1? (See concurring opinion by Judge Hall T. C. Opinion appendix infra).

2. If income may be clearly reflected by a method of accounting embracing the accrual method of accounting for expenses and the cash method of accounting for income, then, must this system allow the deduction of the interest (which in this case was disallowed as a deduction in 1968) as a deduction, under 26 U.S.C. 163, over the period for which it was prepaid, and the resultant loss carry

back under 26 U.S.C. Section 172, and/or 26 U.S.C. Section 6214?

SYNOPSIS OF HISTORY OF CASE

In 1968 the petitioners, James V. and Esther R. Cole, reported their income and expenses under the cash method of accounting, a method consistently used by them.

Their 1968 income consisted of $14,400.00 salary and $10,000.00 bonus from Cole & Paddock, Inc., a corporation, (Cole & Paddock was incorporated in 1965. The partnership remained in existence to collect the then outstanding receivables. The partnership used the cash method of reporting income), $52,908.00 from Cole & Paddock partnership and $2,348.40 interest on a personal note.

Of the $79,656.40 income received in 1968, $54,174.77 was received for work performed, services rendered, or interest accrued prior to 1968 taxable year.

In 1968 petitioners paid in advance of accrual $60,006.00 of interest, such sum representing 60% of the $100,010.00 prepaid interest, for the forbearance of payment of the principal amount of $410,000.00, purchase price of the Regency Apartments.

By agreeing to pay $100,010.00 as prepaid interest upon closing the purchase contract for the purchase of the Regency Apartments, petitioners were extended the benefit of a reduction in purchase price of $25,000.00.

Petitioners only source of funds was their share of the Cole & Paddock net income for 1968 (approximately $60,000.00). Petitioners had enough funds extra to pay their 1968 income tax either on the cash basis or on the accrual basis. However, if petitioners had been on the combination of reporting as imposed by the Statutory Notice of Deficiency, the tax burden would have been in excess of $33,000.00. Because of this tax burden, petitioners could not have purchased the Regency Apartments

except under the cash or accrual basis of accounting.

On their 1968 income tax returns, petitioners deducted $58,947.60 interest under the cash method of accounting.

On April 7, 1972, the Internal Revenue Service issued to petitioners a Statutory Notice of Deficiency requesting the payment of $29,437.96 as a deficiency for the taxable year 1968, claiming thereon, "To properly reflect income, your method of accounting with respect to prepaid interest on the Regency Apartments contract paid to 612 Prospect Associates is changed to allocate the interest over the forty-month period commencing December 23, 1968."

Respondents performed no audit of petitioners' records prior to, or after, the issuance of the Statutory Notice dated April 7, 1972, to determine the method of accounting which would "clearly reflect income"; and to the petitioners knowledge,

performed no audit of tax returns to adequately determine the effect of their proposed change in method of accounting on years subsequent to the year of the change, as well as, those years effect on the year of the change due to the loss carry-back caused by the changed method of accounting.

To this treatment, petitioners objected. After considerable effort to settle by considering the effect of other years upon the year of the alleged deficiency, petitioners took the case to Tax Court.

The Tax Court found in favor of the respondents on September 25, 1975, and the Court of Appeals concurred on November 22, 1978.

On September 12, 1977, petitioners were caused, by attachment of their assets, to pay $29,437.96 in additional taxes for the taxable year 1968, and on October 6, 1977, to pay $16,802.41 as interest, penalties and collection costs.

ARGUMENT FOR GRANTING WRIT OF CERTIORARI

Any reference herein to a section number refers to the Internal Revenue Laws of 1954 as revised to and including 1968, unless otherwise indicated.

In the case at hand, the lower Courts have found that even though there was a bonafide business purpose to the pre-payment of interest, and that the interest prepaid was deductible under 26 U.S.C. Section 163, when paid by a cash basis taxpayer, (page 25 T. C. opinion) (page 3 Court of Appeals opinion) that for petitioners to consider the inter-relation between a business transaction and the tax impact thereon was to "distort" taxable income to such an extent that the Commissioner was extended carte blanche authority to impose upon petitioners a divided and inconsistent method of accounting not properly to be denominated either a cash nor an accrual system, and to calculate and assess under such system without regard to allocating the interest, which was in fact paid and

accrued at the time of assessment (June 7, 1972), to any year except that which had accrued in the last eight days of 1968.

Here, respondent accepts the results under the cash method of accounting of the forward bunching of $54,174.77 of income, but rejects as "distortion of income" under Section 446(b) the deduction of $58,947.60 under the same method.

Respondents are required by Section 446(b) to compute taxable income under such method (not combination of methods) as, in the opinion of the Secretary does clearly reflect income. The Secretary has promulgated what in his opinion does clearly reflect income, by issuance of Regulation 1.446-1. Section 1.446-1(c) (iv) (a) states, "However a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business shall use the cash method in computing expenses of such trade or business."

"Similarily, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business."

Petitioners do not, and have not, objected to a system which would place them on the accrual basis of accounting for both expenses and income, beginning in January 1, 1968, and continuing under the same method of accounting until the interest in question is fully accounted for, such system allowing the loss carry-back to 1968 of the operating loss caused by accounting for the interest under the accrual method as required by Section 172; and accounting for the 1968 income which would be omitted in the year of the change under Section 481(b)(1) (Three year allocation).

Neither Respondents nor the Courts have cited a case in which the taxpayer has been required or permitted to change his method of accounting to a hydrid method (see concurring opinion by Judge Hall, appendix infra). In all cases cited the taxpayer

was required to conform to the method which he had chosen under accepted accounting practice, or the Commissioner was precluded from causing a change.

Of the cases cited by the Court of Appeals for the Ninth Circuit: C.I.R.V. Hansen, 360 U.S. 446, 467 (1959) cited by the Court as a case "requiring another accounting method if the method used does not clearly reflect income". In Hansen, an accrual basis taxpayer, there was never an attempt to change taxpayer's method of accounting. The taxpayer was required to include in income, in compliance with the method which he had chosen, certain "Dealers Reserve Accounts" to which he was held to have fixed rights.

Lucas Structural Steel Co. 281 U.S. 264 (1930) was one of the early cases which established the "First In, First Out" method of pricing inventories.

Stephens Marine, Inc. v. C.I.R., 430 F 2d 579, 686 (9th Cir. 1970) an accrual basis ship contractor, was required to account for its contracts, in

the year of dissolution, on the "percentage of completion" basis. It was held by the Court: "Although the method of accounting utilized by Stephens Brothers may have been perfectly accurate in reflecting the income of an on-going business over the years, when routine was broken by liquidation the Commissioner was empowered to substitute a form of accounting that more accurately reflected income in its final year."

In Photo Sonics, Inc. v. C.I.R. 42 T.C. 926,931 (1964) aff'd, 357 F2d 656 (9th Cir. 1966), held by the Court of Appeals in Footnote 2 of their opinion, to have required another accounting method, under the theory that the timing of a "particular" deduction constitutes a change in method of accounting (assumably under Section 446(b)), the taxpayer was required to include in inventory costing certain manufacturing expenses in conformance with its adopted accrual method of accounting, so as to clearly reflect income as required by Section 471 (General Rule for Inventories).

Petitioners cite four cases directly against a "hybrid" system of accounting:

John D. Fackler, 39 B.I.A 395.

Court Holding Co. 2 T.C. 531,536, (1943), appealed on another issue, reviewed and remanded 143 F. 2d 823 (5th Cir., 1944) and in turn reviewed 324 U.S. 331 (1945).

Boise Cascade Corp. v. United States, 530 F 2d 1367, 76-1 U.S.T.C. 9203 (Ct. Cl. 1976), cert. den. - U.S. - (Oct. 4, 1976). The Court of Claims held that the taxpayer's method did clearly reflect income and that the Commissioner had abused his discretion under Section 446(b) when he imposed another method of accounting. The opinion also noted, "That the accounting method imposed upon (taxpayer) by the Commissioner is a classic example of a "hybrid" system combining elements of the accrual system with a cash system, a mixture generally viewed with disfavor."

Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944), in which the taxpayer was precluded from the use of a "hybrid" method.

The decisions of the various Courts are so opposed in their opinions as to the acceptability of a combination of the cash and accrual methods as to require a re-affirmation of the principle so aptly expressed in the Security Flour Mills case, that is:

"We are of opinion that the purpose of the language which Congress used was not to substitute, whenever in the discretion of an administration officer or tribunal such a course would seem proper, a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system."

WHEREFORE the petitioners respectfully request that the Supreme Court consider this case, and find:

That a combination of methods which encompasses both the cash and accrual methods, as imposed upon petitioners by the Commissioner, does not clearly reflect income.

James V. Cole
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Bainbridge Island, Washington 98110

CERTIFICATE OF SERVICE

It is hereby certified that service of this petition has been made on opposing counsel by mailing three copies thereof to them on this 14th day of February, 1979, in an envelope, with postage prepaid, properly addressed to them as follows:

Carlton D. Powell, Esq.
Tax Division
Department of Justice
Washington, D.C. 20530

JAMES V. COLE

26 U.S.C. SECTIONS AND REGULATIONS SECTIONS

SECTION 163(a)

(a) GENERAL RULE - There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

SECTION 172(a)

(a) DEDUCTION ALLOWED - There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

SECTION 446(a) & (b)

(a) GENERAL RULE - Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS - If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

SECTION 481(a) & (b)

(a) GENERAL RULE - In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")--

(1) if such computation is under a method of accounting different from the method under

which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

(b) LIMITATION ON TAX WHERE ADJUSTMENTS ARE SUBSTANTIAL--

(1) THREE YEAR ALLOCATION--If--

(A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the years of the change, and

(B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase in taxable income were included in taxable income for the year of the change and one-third of such increases were included for each of the 2 preceding taxable years.

SECTION 6211(a)

(a) IN GENERAL - For purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by Chapters 41, 42, 43, and 44 the term "deficiency" means the amount by which the tax imposed by subtitle A or B, or Chapter 41, 42, 43, or 44 exceeds the excess of--

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over--

(2) the amount of rebates, as defined in subsection (b)(2), made.

SECTION 6214(b)

(b) JURISDICTION OVER OTHER YEARS AND QUARTERS-- The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid.

SECTION 1.446-1(c)(iv)(a)

(iv) COMBINATIONS OF THE FOREGOING METHODS (a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business

if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.